00-21
(29)

KIODEX

3 New York Plaza 15th Floor, New York, New York 10004
Toll Free 1 877 6 KIODEX
Telephone 212 483 0080
Fax 212 483 0139

COMMENT

RECEIVED
C.F.T.C.
'00 AUG 7 AM 11 52
OFFICE OF THE SECRETARIAT

RECEIVED
C.F.T.C.
'00 AUG 8 AM 9 18
RECEIVED C.F.T.C.
RECORDS SECTION

August 4, 2000

Office of the Secretariat
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: **Regulatory Reinvention**

Dear Madam Secretary and Members of the Commission:

This is the first opportunity that **Kiodex, Inc.** has had to present written comments[1] to the Commission on its dramatic and important proposals to modernize the federal regulatory framework for exchanges, clearinghouses and intermediaries in light of fundamental changes taking place in the industry's structure as well as the onset of serious competition from abroad. We encourage the Commission to take these critical steps through rulemaking whether or not they become codified in national legislation this year.

About Kiodex.

The name Kiodex comes from the Greek *kiodynos* which means "risk," and the suffix *ex* for exchange.

Kiodex was established as a company in February 2000 although its key personnel represent decades of experience at financial powerhouses including Credit Suisse First Boston, Goldman Sachs and large banks. Most importantly, Kiodex's officials are dedicated to a business formula that they believe to be pre-destined to success:

> *To be a neutral, independent resource to market end users and traders where each and every participant has full and accurate information on which to base intelligent trading decisions.*

Initially, Kiodex will offer - as a *supplier,* not as a competitor or trading colleague - a state-of-the-art risk management application service

---

1 R. Martin Chavez, Ph.D., the Chief Executive Officer of Kiodex, was invited to testify and did testify before the Commission at a hearing on this subject on June 27, 2000.

provider ("ASP") known as the Kiodex Risk Workbench, which Kiodex believes is as good as the proprietary systems major firms employ to manage market risks in a superior manner and to "see" the market more clearly than others.

While the Kiodex Risk Workbench can be integrated with many types of trading systems in an effective and efficient manner, Kiodex will also offer its own Kiodex Trade Engine where orders matched on the Trade Engine flow seamlessly into the Risk Workbench for straight-through processing and review.

Kiodex intends to begin in the over-the-counter derivatives area for complex commodities, a challenging environment with which Kiodex's principals are both experienced and innovative. Working, among others, with the business-to-business physicals, forwards and swaps markets in commodities on the Internet and related media, Kiodex expects to become a leader in the management of not only market risks but also of operational, liquidity and strategic risks.

Above all else, Kiodex is committed to affording to all of its users the same high level of market *transparency* that was once reserved for a favored few houses on Wall Street. It is primarily in support of that creed that we welcome this opportunity to comment on the Commission's "Regulatory Reinvention."

Proposed Part 37: Derivatives Transaction Facilities.

As noted above, Kiodex expects to make its earliest inroads into the business-to-business (or "B2B") market structures with both its Risk Workbench and its Trade Engine. For this reason we have paid especially close attention to the Commission's new framework for such operations in proposed Part 37 of its Regulations dealing with "derivatives transaction facilities" or "DTFs." In general, we are in support of the substance of Part 37.

And we support its seven (7) "core principles." But we urge the Commission to recognize that the administration of "core principles," in order to be both expeditious and flexible, must receive a substantial commitment of resources from the Commission's budget; otherwise, those who provide services to the markets (like Kiodex) and those who use the markets will suffer delays and potential staff reluctance to entertain new approaches, forcing a retreat to the "one-size-fits-all" solutions that the Commission's initiative is meant to discourage.

The definition of "eligible commercial participant." It is unclear to us why some financial institutions are included within this term (e.g., banks, savings-and-loans, insurers) while others are not (e.g., investment programs and brokerage intermediaries). No truly commercial enterprise can conduct relevant trading without broad assistance from a variety of sources that are not literally in the asset transfer business but which provide market-maker services. For example, a substantial share of the liquidity in a particular market may be provided by commodity pools, investment companies and similar trading vehicles that would normally close out positions rather than take physical delivery. To exclude these traders, despite their eligibility for regulatory relief in the context of Part 35, could impair commercial market liquidity without any overriding public protection gains.

Conditions for recognition. While Kiodex finds that the general standards set forth in proposed Regulation §37.2 (Exemption) are reasonable, we note that the requirement in subsection (a)(1) limiting trading to proprietary accounts of eligible commercial participants should ameliorate with respect to those traders the need for creating or enforcing the elaborate "trade abuse" rules contemplated in Regulation §37.3 (Conditions for recognition as a derivatives transaction facility). We suggest that the Commission may wish to distinguish in Regulation §37.3 between those participants on DTFs that do, and those that do not, rely on intermediaries for their transactions.

Kiodex, however, urges the Commission to take a more aggressive position on the minimum requirements of DTFs for market transparency (Regulation §37.3(b)(4) and Core Principle #4). For example, the Commission states in Core Principle #4 that "All market participants should have information regarding prices, bids and offers, or other information appropriate to the market readily available on a fair and equitable basis." We would fortify this statement by saying that "All market participants should have *the same* information as the DTF and its trading owners . . ." The Commission's proposed standard, at present, would seem to demand only the most basic market statistics (e.g., current quotes, price ranges, volume, etc.) and not necessarily the greater details - such as the genuine bid-ask spread or mark-up on a transaction - that is essential to any "fair and equitable" market but that is commonly suppressed by trading systems owned by active market participants. Kiodex intends to disclose all such information at its disposal; we will succeed by removing the "insider advantage" that has long fueled the growth and prosperity of major houses' trading desks. The Commission should not overlook this opportunity to bring genuine transparency to these markets, and in particular to markets owned and controlled by trading interests that have traditionally withheld key market knowledge from even their largest clients.

Procedures for recognition. Kiodex supports the Commission's proposal to complete the DTF recognition process within thirty (30) days following a market's application for that status. We are concerned, however, that the Commission may act under Regulation §37.4(c) unilaterally to convert the review into a full-scale designation proceeding without any prior notice or "cure period" to the applicant. We urge the Commission to provide a grace period during which an applicant may correct an application to conform with Part 37, prior to terminating that avenue of relief.

Retention of fraud enforcement. Kiodex supports the Commission's retention of residual antifraud enforcement authority. While most DTFs, and especially those confined to eligible commercial participants, should experience a substantial reduction in fraud as the role of intermediaries and advisors declines in frequency and scope, the complete elimination of fraud is unlikely. However, we urge the Commission to go beyond transactional misconduct as presently contemplated ("to offer to enter into, the entry into, the confirmation of the execution of, or the maintenance" of positions) and to recognize the duty of the market itself to be open and forthright in the dissemination of all available relevant market information, even if that information is obtained from internal or external sources that would not normally be available to most end users, such as the true bid-ask spread, the mark-up on a transaction or other pricing details that might otherwise be known only to the market or its trading owners. Whether or not a DTF has "fiduciary duties" vis-a-vis its users not to withhold market information which advantages it or its trading owners, an affirmative obligation to disclose all available data (except, of course, for trading intentions or sensitive open positions) should exist and might be enforced by an expansion of Regulation §37.6 to embrace this duty.

Proposed Part 39: Clearing Organizations.

Kiodex concurs in the Commission's view that any market choosing to use a clearing organization for credit enhancement and exposure netting purposes should demonstrate an adequate base of financial resources to support that purpose. The level of those resources, of course, will depend on how much exposure the clearing organization is obliged to undertake and, as an alternative to focusing solely on the financial position of a clearing organization, we urge the Commission to identify and to encourage the value of risk-management at the level of traders and their intermediaries that could substantially reduce the clearing organization's own residual risk.

Although it has become widely recognized that the use of effective risk-management tools like the Risk Workbench is essential to good management of any trading organization, and that a refusal to embrace affordable and available risk-monitoring systems could be criticized as a failure of business judgment, the Commission can make a valuable contribution to the acceleration of this trend by noting in relation to its Part 39 program that clearing organizations which are utilized by traders having proper risk-management systems in place will require fewer financial resources of their own than would be considered necessary if those clearing organizations accepted by default a greater share of the unfiltered risks passed on by their users.

We understand, however, that the Commission does not intend to require the exchanges to use a traditional clearing system so long as there are reasonable safeguards of other types in place to minimize the threat of default. In these cases, especially, we believe that the Commission should expect and should insist that the exchanges will demand of their members or traders the adoption of cutting-edge risk management tools. The adage "the best defense is a good offense" applies to the role that aggressive use of top-grade risk management systems can play in making certain that the conditions for financial calamity are spotted early, addressed quickly, and corrected decisively. An explicit reference in the regulations or in the core principles to the necessity for employing such tools as a condition for regulatory recognition is, in our view, warranted and appropriate.

We would be pleased to provide more extensive comments in person in the event that further hearings are held or an opportunity arises to meet on this subject. In conclusion, Kiodex congratulates the Commission for an historic and bold departure from the traditional "command and control" approach to regulation in our society. We are pleased to be a part of this process which will strengthen the competitive posture of U.S. derivatives markets throughout the world while providing a fairer, safer and more transparent environment for every market user.

Sincerely,

Sean Maloney
Vice President and
General Counsel

cc: The Honorable William J. Rainer
The Honorable Barbara Pedersen Holum
The Honorable David D. Spears
The Honorable James Newsome
The Honorable Thomas J. Erickson

Andrew Lowenthal
Chief of Staff

Paul M. Architzel, Esq,
Chief Counsel
Division of Economic Analysis

Alan L. Seifert, Esq.
Deputy Director
Division of Trading and Markets